

**INDIVIDUAL ABILITY TO PAY MODEL
USER'S MANUAL**

Multimedia Enforcement Division
Office of Regulatory Enforcement
Policy and Program Evaluation Division
Office of Site Remediation Enforcement
Office of Enforcement and Compliance Assurance
United States Environmental Protection Agency
401 M Street, SW
Washington, D.C. 20460

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MAILING LIST ADDITION FORM

If you would like to receive updated materials, and you work for a Federal, State or local government environmental agency, please fill out this form and send it to the address below. If you are a member of the public and would like to obtain these materials, contact the National Technical Information Service (NTIS) at (800) 553-6847. OECA plans to put both the model and this User's Manual on its Web site in early 1998. The address for EPA financial analysis models is: www.epa.gov/OECA/datasys/dsm2.html. EPA has also established a helpline for Federal, State or local government users staffed by the contractor, Industrial Economics, Inc . The phone number is (888) 326-6778, and the e-mail address is benabel@indecon.com.

NAME AND MAILING ADDRESS:

E-MAIL ADDRESS:

PHONE NUMBER:

Please mail the completed form to:

Jonathan Libber (2248-A)
U.S. Environmental Protection Agency
401 M Street, SW
Washington, DC 20460
libber.jonathan@epamail.epa.gov

TABLE OF CONTENTS

INTRODUCTION CHAPTER 1

- A. How to Use the Manual 1-4

USING THE COMPUTER PROGRAM CHAPTER 2

- A. Structure of the Program 2-1
 - 1. Data Requirements 2-2
 - 2. Overview of Computer Program 2-2
- B. Getting Started 2-4
 - 1. Installing from EPA's National LAN 2-4
 - 2. Installing to a PC from Floppy Disks 2-5
- C. Model Attributes 2-9
 - 1. General Features of the Model Screens 2-10
 - 2. Format of the Data Entries 2-10
 - 3. Help System 2-10
 - 4. Correcting Typing Errors 2-10
 - 5. Error Messages 2-11
- D. Ending Procedures 2-11
- E. Printing Options 2-12

DETAILED REVIEW OF MODEL CHAPTER 3

- A. Preliminary Case Screens 3-1
 - 1. Welcome Screen 3-2
 - 2. Main Screen 3-3
 - 3. Case Description Details Screen 3-5
- B. Phase 1 Data Entry Screens 3-8
 - 1. Tax Form Details Screen 3-8
 - 2. Phase 1 Data Input Selection Screen 3-9

3.	Tax Form Data Input Screens	3-9
4.	Phase 1 Analysis	3-12
C.	Phase 2 Data Entry Screens	3-14
1.	Phase 2 Data Input Screen Selection Screen	3-14
2.	Phase 2 - 1040 Data Input Screen	3-15
3.	Model Default Values Screen	3-17
4.	Financial Data Input Screens	3-17
5.	Review of Phase 2 Inputs	3-32
D.	Phase 2 Analysis and Output	3-36
1.	Summary of Applicant's Income Sources Screen	3-38
2.	Applicant's Rated Financial Status Screen	3-39
3.	Ability to Pay Scenario 1: Cash Flow Screen	3-40
4.	Ability to Pay Scenario 2: Loans from Commercial Lenders Screen ..	3-41
E.	Modifying Model Runs and Exporting Cases	3-43
1.	Modifying Data Inputs and Default Values	3-43
2.	Multiple Analyses of an Applicant	3-44
3.	Exporting Cases	3-45

INTERPRETING OUTPUT AND CHANGING DEFAULT PARAMETERS CHAPTER 4

A.	Overview of the Phase 2 Output	4-1
B.	Applicant's Financial Status	4-2
C.	Ability-to-Pay Scenarios	4-9
1.	Scenario 1 - Available Cash Flow	4-9
2.	Scenario 2 - Debt Capacity	4-14
D.	Flags	4-18
1.	Applicant's Filing Status	4-18
2.	Complex Income Sources	4-18
3.	Under-Reported Income	4-19
4.	Under-Reported Market Value of Interest-Bearing Assets	4-19
5.	Inconsistent Home Mortgage Deduction	4-20
6.	Under-Reported Market Value of Real Estate	4-20

7.	Income Variation	4-20
8.	Negative Net Worth	4-21
9.	Liabilities Exceed Assets with Contribution from Cash Flow	4-21
10.	Excessive Debt Payments with Contribution from Cash Flow	4-21
11.	Expenses Exceed Income with Additional Loans	4-22
12.	Liabilities Exceed Assets with Additional Loans	4-22
13.	Excessive Annual Debt Payments	4-22
14.	Potential Financial Issues	4-23
E.	Changing the Model's Standard Values	4-26
1.	Rate of Return	4-26
2.	Commercial Loan Rate	4-27
3.	Smoothing Constant	4-27
4.	Years of Available Cash Flow	4-29

Appendix A: TECHNICAL APPENDIX

Appendix B: INDIVIDUAL FINANCIAL DATA REQUEST FORM

In environmental enforcement cases, the defendant/respondent may claim an inability to pay the penalty or environmental expenditure (i.e., contribution to cleanup costs) sought by the U.S. Environmental Protection Agency (EPA). Under the goal of fair and equitable treatment of the regulated community, EPA policy states that the ability of violators to pay should be considered when determining penalty amounts.¹ Inability to pay is identified as one circumstance of "compelling public concern" under which an enforcement case may be settled for less than the economic benefit of noncompliance.² EPA policy further explains that such settlements are allowed if "removal of the economic benefit would result in plant closings, bankruptcy, or other extreme financial burden, and there is an important public interest in allowing the firm to continue in business."³ Nevertheless, if a violator either refuses to comply, has a long history of previous similar violations, or has committed egregious violations, EPA reserves the right to seek penalties that might adversely impact a business, or even put it out of business.⁴

The ABEL model has been used since the 1980s to evaluate the financial health of corporations. Up to this time, however, a corresponding tool to evaluate the financial status of individuals was not available. The Individual Ability to Pay Model (INDIPAY) fills this gap.

¹ This policy is set forth in U.S. EPA, *Policy on Civil Penalties*, February 16, 1984, codified as PT. 1-1 in the General Enforcement Policy Compendium (previously codified as GM-21).

² U.S. EPA, *A Framework for Statute-Specific Approaches to Penalty Assessments*, February 16, 1984, Codified as PT. 1-2 in the General Enforcement Policy Compendium (previously codified as GM-22), pp. 12-13.

³ Ibid.

⁴ Ibid. at p. 23; U.S. EPA, *Guidance on Determining a Violator's Ability to Pay a Civil Penalty*, December 16, 1986, codified as PT. 2-1 in the General Enforcement Policy Compendium (previously codified as GM-56).

The Individual Ability to Pay Model is a sophisticated screening tool developed to assist enforcement professionals in evaluating ability to pay claims made by individuals. It is designed to be used principally in negotiations. The Individual Ability to Pay Model is generally not intended for use at a trial or in an administrative hearing. If the Agency is going to present ability to pay testimony in these settings, the Agency should rely on an expert to provide an independent financial analysis.⁵

The Individual Ability to Pay Model is designed to make a preliminary evaluation of the financial condition of private individuals. These individuals may operate businesses as sole proprietorships or partnerships. Gas stations, dry cleaners, and local landfill operators are all examples of small businesses that frequently are organized as sole proprietorships or partnerships. Sole proprietorships and partnerships do not pay any income tax. Instead, the income and expenses generated by the business are paid by the sole proprietor or partner, who reports the income and expenses on his or her personal income tax return. The concept of legal liability for actions taken by a sole proprietorship or partnership parallels this tax treatment in that the owner or partner is *individually* liable for the debts of his or her business. Unlike corporations in which the shareholders' liability is limited to their investment in the firm, the total financial resources of the individual sole proprietor or partner may be garnished for liabilities incurred by their business.⁶ Under some circumstances, shareholders in S corporations should also be evaluated as individuals using the Individual Ability to Pay Model.⁷

The financial status of individuals is often difficult for enforcement professionals to evaluate because standardized reports similar to a corporation's financial statements or tax return are not readily available. Both a corporation's financial statements and tax returns list its assets, liabilities, income, and expenses. An individual's tax return (e.g., Form 1040), in contrast, provides a statement only of his or her income. Occasionally, an individual or sole proprietorship produces a financial report, but most often these reports are unaudited and, therefore, less reliable. The Individual Ability to Pay Model is designed with this consideration in mind, adapting the ability to pay screening analysis to the most reliable source of individual financial data -- the applicant's federal income tax

⁵ For assistance with the selection of an expert on ability to pay and financial analysis, EPA staff should call Jonathan Libber, the BEN/ABEL coordinator, at 202/564-6011. For selection of an expert in Superfund and other site remediation cases, contact Tracy Gipson of the Office of Site Remediation Enforcement's Regional Support Division at 202/564-4236.

⁶ The Individual Ability to Pay Model can be used to evaluate the ability to pay of partners in both general and limited partnerships. In a general partnership, all of the partners owning a business are individually liable for its debts. Thus the analyst should run the Individual Ability to Pay Model for every partner in the firm. However, since limited partnerships have only one general partner, who is the only partner liable for all the firm's debts, an analyst evaluating its ability to pay should only evaluate the financial condition of that partner.

⁷ Consult the EPA or DOJ attorney responsible for the case.

return. The model also relies on information taken from an individual financial data request form -- a questionnaire completed by the defendant/respondent that itemizes his or her expenses, assets, and liabilities.⁸ A copy of this form is provided in Appendix B of this manual.

The Individual Ability to Pay Model provides a consistent and theoretically sound framework for screening evaluations of ability to pay cases involving individuals, sole proprietorships, and partnerships. Using a two-stage process, the model applies standard financial principles and analytical techniques to make ability to pay determinations. Exhibit 1-1 presents a flow diagram outlining the structure and major analytical steps embodied in the model. The analytical processes in each step vary slightly depending on the tax form filed by the applicant, but the underlying methodology presented below and in Exhibit 1-1 is the same.

As shown in Exhibit 1-1, Phase 1 of the model subjects all claims to a quick assessment based on the applicant's income. The data entry for Phase 1 is minimal, requiring only a few minutes to complete. If the applicant's adjusted gross income is less than the low income level for the applicant's household size and county of residence, and there is no evidence that the applicant has significant assets or complex personal finances, then the model concludes that the applicant has no ability to fund a penalty or contribution (i.e., the applicant's ability to pay claim is valid). However, if the applicant's adjusted gross income exceeds the low income level or there is evidence that the applicant has significant assets or complex personal finances, the model instructs the analyst to proceed to Phase 2.

In Phase 2, a more comprehensive ability to pay analysis is conducted, evaluating the applicant's annual cash flow, living expenses, debt obligations, assets, and liabilities. While this section of the model is designed to provide a thorough analysis of the applicant's finances, the model is still a screening tool which uses a limited amount of information. When the applicant has very complicated finances, the user should seek the assistance of an expert, and at various points in the Phase 2 analysis the model may prompt the user to do so. Data entry and verification required for a typical Phase 2 analysis takes approximately thirty to forty-five minutes. Once input, the model processes the data, culminating in a summary of the applicant's financial status and capacity to fund a penalty or contribution. This analysis provides the model's user with valuable information regarding the applicant's financial situation. It is important to note, however, that individual ability to pay cases require considerable judgment. For instance, analysts must often evaluate whether an applicant's living expenses are over- or understated or determine whether particular assets are available for payment. The model is designed to help with these judgments, but final determination of the appropriate penalty or contribution ultimately is a decision only the enforcement professional can make.

⁸ For partnerships and sole proprietorships, the assets and liabilities of the business should be reported on the individual financial data request form completed by the liable partner(s). The business's income and expenses are reported directly on the partners' income tax returns.

The user should be aware that, like the ABEL model, the Individual Ability to Pay Model calculates an applicant's ability to pay a penalty or contribution levied in the future based upon past income and expense levels. Therefore, if the applicant indicates that his or her finances will change substantially in the next several years, the Individual Ability to Pay model may provide an inaccurate ability to pay estimate. In such cases, the user should consult a financial expert.

A. HOW TO USE THE MANUAL

This manual provides instructions for using the Individual Ability to Pay Model. These instructions illustrate the model with a hypothetical example and demonstrate a typical model run. Chapter 2 describes the preliminary steps needed to use the Individual Ability to Pay Model, including how to access the model on EPA's national LAN. Chapter 3 provides a step-by-step guide for each of the model's screens. These instructions demonstrate the mechanics of using the model. Chapter 4 describes the model's results and output, and explains how to change input values for subsequent runs. Appendix A provides the model's equations and describes the ability to pay calculations. Appendix B provides a copy of the Individual Financial Data Request Form that the applicant must complete.

Help information is available in the program if you need a variable defined, guidance on information sources, or help with the format required for an input entry. To access help, click the "Help" button located at the base of each screen or press the F1 key. If you need assistance in operating the program, understanding the results, or other guidance in using the model, contact Jonathan Libber, the BEN/ABEL Coordinator at 202/564-6011. For questions specific to Superfund and other remediation cases, contact Bob Kenney, Office of Site Remediation Enforcement, Policy and Program Evaluation Division at 202/564-5127.

THE INDIVIDUAL ABILITY TO PAY PROCESS

